ORF ISSUE BRIEF

AUGUST 2014 ISSUE BRIEF # 73

The Centre-State Fiscal Relationship: A Critique & Recommendations

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Introduction

The federal structure in India is a three-tiered constitutionally demarcated system that allocates funds according to specific functions as listed in three separate mandates. The Constitution of the country stipulates the role and responsibilities of the three tiers, differentiating according to the macro or micro nature of the issue. For example, the Centre is responsible for matters of national importance such as defence, transportation infrastructure, international trade and macroeconomic management. The State, governed by the State list is responsible for matters of regional and State importance such as law and order, public health, sanitation, housing, irrigation, agriculture and local governments. The final tier is the Concurrent list, which includes sectors such as education, contracts, bankruptcy and insolvency, economic and social planning, employment and labour welfare, electricity, stamp duties and any other sectors that require Centre-State consensus.

The federal structure of India stems from the realisation by post-independence policymakers of the differences in languages, cultures and traditions of the many States and regions across the country. While it was possible for the British to control the colony through a central administrative and fiscal authority, India's vast differences between regions forced the newly formed central government to concede some power to local regional authorities. Ironically, two decades prior to the enactment of the Government India Act 1935, regional provinces and princely States had to make a contribution to the Union.

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The Constitution of India has distinct "quasi-federal" features. Many important features of the Act were formally incorporated into the Constitution including a bias towards the Centre in administrative and judicial arrangements. This centripetal bias in fiscal policy was seen primarily in the deliberate conferment of residuary powers to the Centre. Over time, Centre-biased quasi federalism became more entrenched in the Indian system. For example, the nationalisation of major financial institutions including banking and insurance in 1969 was a sweeping change that resulted in reducing the States' ability to deal with banks directly.

The 73rd constitutional amendment in 1992 provided statutory recognition of local government and States. The amendment further stipulated a long list of functions and sources of funds for both rural and urban local bodies. Additionally, each State was mandated to appoint a State Finance Commission for allocation of taxes and fees to local government as well as recommending the State's tax devolution and grants.

While the system put in place by the post-independence government may have been suitable for that time, the central-State fiscal relationship has not changed to reflect the evolution of the country's fiscal set-up. The much criticised relationship is marred by an archaic understanding of the dynamics of the relationship, perpetuating a misbelief that the Centre perhaps knows what is still best for States and their denizens. Further, institutions set up by previous governments to oversee fund division and allocation have now become irrelevant in the modern Indian system. The relationship itself is in need of immediate reform, without which the division and alienation of some States will continue. This brief aims to deconstruct the Centre-State fiscal relationship by describing the current status quo, explaining criticisms of the relationship and providing some policy recommendations to correct and update the relationship such that it reflects the changed and evolved fiscal structure of the country, its States and its people.

Objectives for Inter-Governmental Allocation of Funds

According to the existing literature, there are two primary purposes for inter-governmental distribution of funds. These are:

a) To close the fiscal gap;

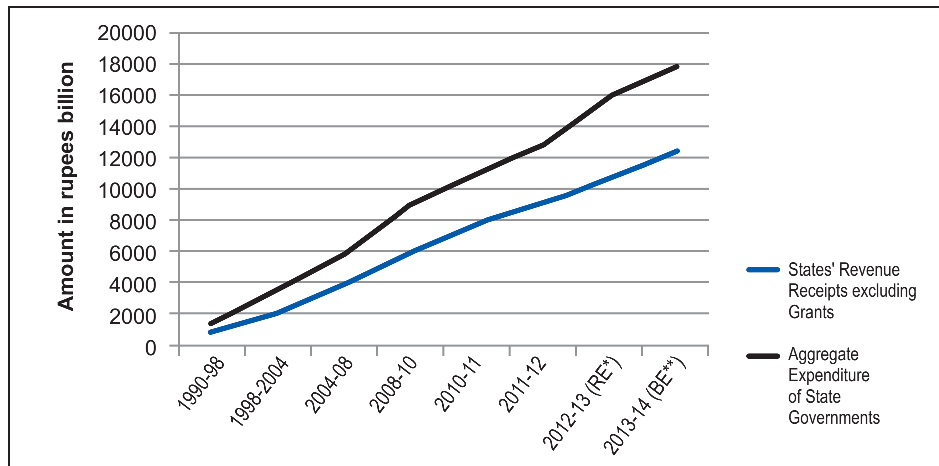
b) To balance inter-State capacities.

Closing the Fiscal Gap

A dominant reason for the differences in fiscal capacities between the Union Government and the State governments, or even among State governments, is the disparity in the taxation capacity and expenditure responsibilities of the respective governments. Given this system of taxation and expenditure assignment, the States are unable to match their expenditures to their revenues. This is generally known as the vertical fiscal imbalance. Due to such a mismatch, the Centre is required to

allocate funds in order to overcome this inadequacy. Despite the increase in revenue at the State level, dependence has risen even further. This is because while revenue has been experiencing a steady increase, it has been unable to keep up with the fast rising expenditure.

Figure 1: Revenue and Expenditure of States



Source: State Finances, Reserve Bank of India *Revised Estimates **Budget Estimates

Apart from vertical imbalances, the States face the additional challenge of a horizontal disparity.[1] Different States face different degrees of inadequacy. This is because there is no uniform tax base. Further, spending also varies. Given such divergence, there is a need for certain balancing mechanisms.

Table 1: Percentage Distribution of Tax Revenue

(As ratios to respective total of non-special and special category State to which a State belongs)

	Tax Revenue (%)		
State	2011-12	2012-13 (RE)	2013-14 (BE)
Non-Special Category			
Andhra Pradesh	9.3	9.2	9.3
Bihar	5.3	5.5	5.6
Chhattisgarh	2.2	2.3	2.3
Goa	0.4	0.5	0.4
Gujarat	6.8	6.9	6.7
Haryana	3	3	3.1
Jharkhand	1.8	1.9	1.9
Karnataka	7.5	7.3	7.4
Kerala	4.2	4.3	4.5
Madhya Pradesh	5.9	5.7	5.5
Maharashtra	13.2	12.8	12
Odisha	3.4	3.2	3.2
Punjab	2.9	3.1	3.2
Rajasthan	5.3	5.3	5.2
Tamil Nadu	9.5	9.8	9.9
Uttar Pradesh	13.5	13.3	13.5
West Bengal	5.7	6	6.2
Special Category			
Arunachal Pradesh	2.3	2.6	2.4
Assam	34.3	33.5	33.5
Himachal Pradesh	12.4	13	12.5
Jammu and Kashmir	16.7	17.8	17.3
Manipur	3.1	3.1	3.2
Meghalaya	3.5	3.4	3.5
Mizoram	2	1.8	1.8
Nagaland	2.2	2.1	2.2
Sikkim	1.8	1.9	1.9
Tripura	4.4	4.5	4.6
Uttarakhand	17.2	16.5	17

Source: State Finances, Reserve Bank of India

Balancing Inter-State Capacities

As mentioned above, States have diverse revenues and spending requirements. Thus, there is a need for redistribution to attain parity. Broadway and Flatter[2] provide an excellent definition of this phenomenon. They State that to maintain parity, two equally well-off individuals, residing in different provinces, should be equally well-off post taxation and the provision of public goods. In short, their residing in two different provinces should not affect their well-being. Thus, disparities among States should not affect the well-being of two similar individuals, each staying in two different States. This is in some way addressing the issue of horizontal disparity.

The Process of Allocation of Funds

Due to the existing imbalances of a quasi-federal structure of government, the country practices transfer of funds through four channels. Allocations primarily take place through two commissions – the Finance Commission and the Planning Commission. The third channel is through Centrally Sponsored Schemes. These funds are generally provided for some specific purpose. Such schemes are conducted through a cost-sharing mechanism between the Centre and the State. Lastly, the States have the option of borrowing from the market. Further, it is mandatory for commercial banks to retain 35 percent of their lendable resources in the form of certain more liquid assets (the Statutory Liquidity Ratio). State government bonds are one type of such assets.[3] Thus, banks have an incentive to purchase government bonds.

This section expands on the objectives and process of federal transfer employed by the commissions mentioned above. In doing so, it explains how the government has tackled both equity and efficiency concerns.

The Finance Commission

The Finance Commission's fund allocation responsibility is limited only to non-plan current expenditures due to the presence of the Planning Commission performing similar functions.

As per Article 280 of the Constitution, the Prime Minister appoints the Finance Commission every five years. The Commission transfers the funds through the following steps:[4]

i. Estimating the overall budget available as per the total resource requirement of the Union and the States;

ii. Estimating the current revenues and non-plan expenditures of States;

iii. Assessing the proportion of Central tax proceeds to be assigned to the States and allocation of these among them; and

iv. Providing Grants-in-Aid to close any gaps between non-plan current expenditures and revenue.

Devolution of tax proceeds, as mentioned in step three, is aimed at addressing the above-mentioned vertical and horizontal imbalances. While the very act of devolution is meant to take care of vertical imbalances, weights have been assigned to certain key factors in order to correct horizontal imbalances. The primary objectives behind the transfers are economic efficiency and deterring fiscally inducted migration within the country.

The Thirteenth Finance Commission (FC-XIII) has employed four criteria for the devolution of taxes:[5]

i. **Population:** This factor is aimed at ensuring equity across States. With rising population overall needs also increase. It is rightly assumed that a State with higher population requires more funds to make sure that residents receive comparable degree of public goods as in other States. The FC-XIII has assigned a weight of 25 percent for population.

ii. **Area:** This factor is also aimed at equity by taking into account the varying cost disability of different States. Larger States must incur higher administrative costs for public service delivery. Following this rationale, this criterion has received 10 percent weight.

iii. **Fiscal Capacity Distance:** This factor is based on the principle of raising efficiency. It aims to incentivise States to increase tax efforts while taking into account the fiscal disadvantages of the States. For instance, regions with a hilly terrain (such as the north-eastern region) are at a disadvantage. FC-XIII has assigned 47.5 percent weight for fiscal capacity distance.

iv **Fiscal Discipline:** Apart from the equal distribution of resources, it is important to curtail inefficient utilisation. The Commission thus recommends rewarding prudent resource utilisation. 17.5 percent weight is assigned to this factor (which is 10 percent higher than the previous Commission).

Table 2: Criteria for Tax Devolution assigned by the Thirteenth Finance Commission

Sl. No.	Criterion	Weight (%)
1.	Population	25
2.	Area	10
3.	Fiscal Capacity Distance	47.5
4.	Fiscal Discipline	17.5

The Planning Commission

Unlike the Finance Commission, whose goal is fiscal equalisation, the Planning Commission is more development oriented.[6] It transfers funds in order to increase the fiscal capacity of the States. This transfer takes place through two mechanisms – loans and grants. Earlier, the components of these mechanisms were primarily project-based. However, post-1969, the Planning Commission follows the Gadgil Formula. This formula has been revised multiple times and the current version being used is known as the National Development Council (NDC) revised Gadgil-Mukherjee Formula.

The process of transfer for Special Category States differs from the other major States.11 mountainous States of North and North-East India have been classified as Special Category States due to their distinctive economic capacities and requirements.[7] The Planning Commission allots 30 percent of the total funds to these States. Of this, 90 percent is given away as grants and the rest is provided in the form of loans. 70 percent of the total funds are allocated to the rest of the States. This is distributed through the Gadgil-Mukherjee Formula (see Table 3 below).

Table 3: Formula adopted by the Planning Commission for allocation of funds[8]

Variable	Weight (%)
Population (1971)	60
Per capita State Domestic Product (SDP), of which:	25
i. Deviation from the average to the States below average per capita SDP	20
ii. 'Distance' from the highest per capita SDP for all the general category States	5
Fiscal Performance, of which:	7.5
i. Tax effort	2.5
ii. Fiscal management	2.5
iii. National objectives	2.5
Special Problems	7.5
Total	100

Criticism of the Centre-State Fiscal Linkages

Fiscal linkages in the country have not changed much since independence and have perhaps become more cemented. The struggle and the debate between the Centre and States has not only survived since the policy formulation but has gained momentum and strength over the years as well. While there are many arguments against the current system, the more important ones tend to revolve around one basic problem. It is this problem that has hindered the reformation of this relationship and further prevented it from modernising and evolving with time and changing economic environments.

In simplest terms, the basic problem is one of politics. It has become the strongest strain on the relationship, especially for States represented by parties in the opposition or out of central favour. Fund allocation has also become a measure of enticement to join certain political alliances and as a form of punishment for those in the opposition.[9]

The other major argument against the current relationship is its over-emphasis on need-based fund allocation rather than merit-based, which disillusions States performing well. Furthermore, provisions of special status given to certain States and decentralisation of decision making with regards to allocation of funds for economic activities are also points of contention.

The three most important criticisms of the federal finance structure in the country are as follows:

1. No allocation autonomy for States for funds dispersed by the Centre
2. Need-based allocation versus merit-based allocation
3. Allocation as a political tool

No allocation autonomy for States on funds

The currently used practice of allocation of certain funds to any State is in the form of schemes, which themselves carry guidelines on usage of said funds. Often named after political leaders, these funds are given for specific purposes and issues that the Centre believes are vital for the State, often circumventing what may be actually required in such States. The purpose of State governments is to represent the needs and demands of the local population and by this virtue, in most cases, they are a better judge of the importance/relevance of an issue. It is thus the argument of States that without autonomy to decide on the usage of such funds, large amounts of resources are often invested in activities that are beneficial neither to the local population nor, in the long run, to the Centre itself.

For example, allocating large amount of funds for rural electrification in a State like Gujarat is inefficient allocation because Gujarat has the highest level of State electrification. Though there is always a need to improve electricity connections, even in Gujarat, giving the State the same amount of funds as, say, Jharkhand or Madhya Pradesh is counter-productive because remainder funds not used to improve the already fledgling electrification programmes will either remain unused (as they cannot be used for other purposes) or will be used toward rent-seeking and corruptive practices.

Hence, many State governments opine that autonomy must be allowed in the allocation of central funds. This will allow the local government body to decide and choose the more pressing issues and resources needed for activities rather than these being forced upon them from someone outside the local system. Without autonomy, funds will continue to go to schemes and programmes that may or

may not be beneficial for the intended segment of population or the State, effectively wasting precious resources and even increasing changes of corruption, bribery and misuse.

Need-based allocation versus merit-based allocation

When allocating funds for sectors like education and employment, the adopted practice of the government is based on merit rather than need. In fiscal transfer and linkages, the method is the exact opposite. The idea is that worse performing States should be given preference in fund allocation over the better performing States.

The opposing argument is that better performing States feel that their contribution to the national revenue kitty is being punished rather than being rewarded. Justification for this method is based on the theory that by giving funds to States that qualify under the need-based model, the funds would generate and spur economic activity. However, States feel that investment in economic activities yielding healthy returns – would continue the positive cycle, create more surplus over time and reduce the requirement of allocation from the Centre. But this cannot be achieved if central funds are being diverted elsewhere, into economic activity that is not currently producing returns, in those States which are not performing economically well.

The argument boils down to one between short-run versus long-run gains. In the short-run, re-investment in healthy economic activity will result in higher returns from that activity, making the State less reliant on fiscal transfers from the government. The flip side is that investments made in sickly economic activity or under-performing States will spur economic growth and boost returns.

The problem here is in the second theory. Long-run investments spurring economic growth are subject to a plethora of variables that are required to revive a sector. As one of the reasons for this under performance leading to requirement of long-term investment could be systemic problems within the State, pumping resources could simply be adding fuel to the lit fire. Furthermore, reviving economic activity at that scale and bringing the sector to a self-generating level can take years of investment. The problem with the long-run view is thus also that by diverting funds towards less economically healthy activities, the Centre is taking away from successful programmes.

The main goal of central transfers should be to create an economic system that is less dependent on central accounts than the year before. Current weightage in the methodologies adopted by the Finance Commission and the Planning Commission both heavily disfavour merit-based allocation (17.5% and 7.5% of total weight, respectively). This is not to say that need-based allocation in not necessary; infact, it is equally necessary, but long-run investments to revive economies over short-run

investments to boost positive performance will keep not only the need-based States dependent on central funds but may also bring better performing States back into the fold of dependency.

Allocation as a Political Tool

The strongest criticism of central-State fiscal linkage is that many times this relationship is dependent on the political relationship the State has with the central government. It is often seen that if a State is governed by a party not in an alliance or relationship with the central political party, it is given less priority or favoured less than those States that are politically inclined toward the Centre. While the equation used to allocate funds and the mandate of the Finance Commission is non-partisan, political favouritism is still a regular occurrence. A State ruled by the opposition is less likely to receive special status or special funds than a State that is ruled by the central governing party. Moreover, special status and special funds are given to States to buy their political alliances. While some examples such as the North-East States, where economic activity is low due to terrain, climate and their proximity to foreign borders, are justifiable for special status, bestowing it on States like Bihar, Odisha and Uttar Pradesh was more a political decision than anything else.

Irrelevance of the Planning Commission

The relevance of the Planning Commission (PC) has been questioned time and again by experts and policymakers alike. With existing commissions that perform the duties of the PC, the redundancy of keeping the PC is unwarranted. The debate, which started by questioning the relevance of the Commission, now ranges from complete reformation of its mandate to its dismantling. The criticisms of the commission are as follows:

First, the basis on which the PC was created was to set up an organisation that would formulate economic policy for newly formed and economically weak States in the union, coordinate between ministries and government institutions, and act as a unit that would cover areas not overseen by a specific ministry. Over time, the economic status of States has changed enormously, through functioning economic units within each State. Thus, the need for policy formulation has transferred from the Commission to the State governments and planning boards. Additionally, in 1951, when the PC was created, economic activities such as urban development, steel, corporate affairs, atomic energy, shipping and earth sciences were not represented by a specific ministry but were put under the Commission's charge. This deficit of specific ministries no longer exists and the mandate of the PC has thus been reduced, as specific ministries are now incharge of overseeing the strategy, planning, coordination and implementation within specific sectors.

Second, the Finance Commission, already responsible for formulating and calculating the equation used for allocation and transfer of funds, is well suited to handle the actual allocation itself. An additional 'independent' authority serves little purpose, especially if a separate commission is already tasked with designing and implementing financial transfers.

Third, the PC's association and proximity to the central government, especially as the appointment of the organisational head of the Commission is a politically motivated nomination, negates the independence of the unit in taking Centre-State fiscal decisions without any political bias. The political leaning of the Commission further exacerbates the issue of using resource allocation as a tool for political gain for favoured States or political punishment and isolation of non-alliance States. Fourth, the original design of the Commission envisioned encompassing policy matter experts in making decisions about resources allocation and scheme creation. This practice is no longer actively encouraged, with ranks and offices filled by senior bureaucrats or political appointments.

The original mandate of the Commission was to advise the Prime Minister's Office (PMO) on various developmental issues using the expert opinions of domain specialists, particularly on issues that may have not been easily understood by decision-making officials in the central government. The PC's original mandate also required in-depth research and analysis towards creating policies and schemes for the country and providing criticism of central activities. However, the current mandate of the Commission has shifted to supporting claims and policies of the government even if they are far removed from ground realities. The prime example was the creation of the Rs 28/day poverty line, which has not only been argued as a miscalculated figure but also a measure to boost the performance of the previous government.

Finally, the Commission has been accused of using outdated methods for calculating allocations and creating policy that is not in line with either evolving economic systems or needs of the various stakeholders and recipients. Without in-depth research and analysis, the PC's role in the formulation of policy is not only lacking cohesion with economic realities but in a manner is obsolete.

Policy Recommendations

The importance of a sound Centre-State relationship, especially for fiscal transfers, is indubitable. Homogenous development across States regardless of political affiliation must be the mandate of any government or organisation working in the economic system. Concomitantly, robust policies that incorporate the need of some and the merit of others, as well as local knowledge and domain expertise, must be designed by governmental organisations and commissions that are reformed to suit both the continuously evolving geo-economic landscape and changing dynamics of Centre-State relationship. Listed below are some recommendations for the federal finance system of India:

- The Gadgil-Mukherjee formula to calculate the allocation of resources for States must be revised to incorporate merit and need-based allocation.
- State governments that have better knowledge of local conditions and requirements must be given autonomy in decision-making on allocation and usage of resources provided by the Centre. While the Centre may furnish certain directions, resources will be better spent if operational authority is given to local functionaries.
- Successful economic programmes of States must be rewarded by resources such that they are able to continue to generate growth, employment and revenue. Short-term revenue return investments must be made such that States can inch closer to financial independence. Long-term revenue return investments in economically weaker States must also be encouraged but resources should be allocated efficiently and monitored thoroughly.
- The weightage given to merit-based allocation must be brought at par with weightage for allotment based on need. The current standard leans heavily towards need-based rather than merit-based provision, disincentivising continued economic and fiscal discipline.
- States performing economically better than others, i.e. which provide higher returns to the national accounts, must be incentivised to continue successful economic activity so as to continue returns. Fiscal transfers should depend more on previous returns to national accounts rather than simply a need-based demand.
- Allocation of funds must be independent from politics and must not be used as a political tool. Independence and autonomy of the commissions involved in the decisions concerning allocations is of paramount importance. In this regard, commission members and the chairmen must be selected through a bi-partisan process rather than by political appointment. Special status categorisation must be either based on need or merit rather than for political gain as is often used.
- The mandate of the Planning Commission to allocate funds, while the mandate of the Finance Commission to devise the equation for such allocation, must be brought under the ambit of one single agency. The Financial Commission can be responsible for both formulation of the equation and the decisions on actual allocation
- The role of the Planning Commission should be narrowed to inter-ministry coordination, State-Centre coordination, monitoring and evaluation and in-depth research and analysis for support of policies and programmes.
- The Planning Commission's association with the PMO, with the Prime Minister as the chairman, must be discontinued and members and officers of the commission must be selected through a scrutinising selection process based on their domain expertise rather than political and bureaucratic affiliations.

- Overarching national schemes and national populist measures must be replaced by targeted plans and programmes designed in consultation with domain experts and State representation.

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